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10 SUPERIOR COURT OF THE STATE OF CALIFORNIA

11 COUNTY OF SACRAMENTO

12
13 THE PEOPLE OF THE STATE OF
14 CALIFORNIA,

15 Plaintiff,

16 v.

17 PA DISTRIBUTORS LLC, a limited liability
company and DOES 1 through 100, inclusive,

18 Defendants.
19

CASE NO.:

COMPLAINT FOR CIVIL PENALTIES
AND INJUNCTIVE RELIEF BASED ON
VIOLATIONS OF THE CALIFORNIA
CORPORATE SECURITIES LAW OF
1968

[Corporations Code sections 25401 and
25216: Antifraud Provisions]

20 Plaintiff the People of the State of California, by and through Bill Lockyer, Attorney
21 General of the State of California, allege as follows:

22 **PLAINTIFF AND JURISDICTION**

23 1. Bill Lockyer is the duly elected Attorney General of the State of California and is
24 the chief law officer of the State. The Attorney General is authorized by Government Code
25 sections 12658 and 12660 to bring actions in the name of the People of the State of California in
26 the superior court to enforce the Corporate Securities Law of 1968 ("CSL").

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DEFENDANT

2. Defendant PA Distributors LLC (“PAD”), is, and at all times mentioned herein was, a limited liability company organized and existing under the laws of the State of Delaware. At all times mentioned herein, PAD served as the distributor and principal underwriter of PIMCO Funds: Multi-Manager Series and PIMCO Funds: Pacific Investment Management Series family of mutual funds (collectively, “Funds”) and was a “broker-dealer” and an “underwriter” as defined pursuant to Corporations Code sections 25004 and 25022, respectively.

3. Whenever reference is made in this complaint to any act or transaction of a defendant such allegation shall be deemed to mean that said defendant and, if a business, its owners, officers, directors, agents, employees, or representatives, did or authorized such acts while engaged in the management, direction, or control of the affairs of the defendant and while acting within the scope and course of their duties.

4. Whenever reference is made in this complaint to any act of defendants, such allegation shall be deemed to mean the act of each defendant acting individually and jointly with the other defendants named in that cause of action.

5. At all times mentioned herein, each defendant knew that the other defendants were engaging in or planned to engage in the violations of law alleged in this complaint. Each defendant nevertheless intended to and did encourage, facilitate, or assist in the commission of the unlawful acts, and thereby aided and abetted the other defendants in the unlawful conduct.

6. The violations of law which are the subject of this action occurred throughout the State of California, including but not limited to, the County of Sacramento.

7. The true names and capacities, whether individual, corporate, or otherwise, of defendants sued herein under the fictitious names of DOES 1 through 100, inclusive, are unknown to plaintiff who therefore sues these defendants by using fictitious names. Plaintiff will amend this complaint to show the true names of each when the name has been ascertained.

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SHELF-SPACE AGREEMENTS -- A MUTUAL FUND INDUSTRY-WIDE PRACTICE

8. Plaintiff brings this action in response to a mutual fund industry-wide practice involving undisclosed, and mostly oral, agreements between mutual fund complexes and certain securities broker-dealers (“broker-dealers”) who sell the funds' shares to California investors. These undisclosed agreements benefit the mutual fund complexes and these broker-dealers to the detriment of mutual fund investors.

Background

9. A mutual fund is a fund operated by an investment company that raises money from shareholders and invests it in securities. Mutual funds bring the benefits of professional management, portfolio diversification, and securities ownership to millions of individuals. Today, over 91 million individuals, comprising nearly half of all U.S. households, own shares in mutual funds. The majority of these individuals represent households with moderate annual incomes between \$25,000 and \$75,000. These individual mutual fund investors can choose from over 500 mutual fund complexes offering over 8,000 mutual funds to save for their future. Robust competition - on a level playing field - among mutual fund complexes benefits shareholders by providing investment choice, diversified investments, easier methods to invest and innovative customer services.

10. Mutual funds are distinct legal entities owned by the shareholders of the fund. Each fund contracts separately with an investment adviser who provides management, portfolio selection and administrative services to the fund. A mutual fund’s accrued daily operating costs are periodically deducted from the fund’s assets. These costs include such items as the fee paid to the fund’s investment adviser for managing the fund, accounting expenses and the cost of preparing fund documents. A board of directors reviews each mutual fund’s operations and represents fund shareholders’ interests. This review includes monitoring for conflicts of interest between the fund and its adviser.

11. A mutual fund sells shares through a variety of distribution channels. For example, investors can buy shares directly by telephone or mail or they can be sold by a sales staff employed by the mutual fund complex’s distributor. Mutual funds may also sell shares

1 through third parties broker-dealers or their account representatives. A mutual fund may
2 compensate these third party financial professionals by levying a sales charge based on a
3 percentage of the amount being invested - called a load - that the investor can either pay when
4 making the investment (a front-end load) or later when selling or redeeming the shares (a back-
5 end load). Mutual funds marketing shares through third party financial professionals may also
6 charge investors ongoing fees as compensation for costs expended in marketing the fund or for
7 servicing the investor's account. Third party and fund-affiliated broker-dealers may also offer
8 fund supermarkets. These allow investors to purchase and redeem shares of mutual funds from a
9 wide range of fund companies through the customers' accounts at the broker-dealer operating the
10 supermarket.

11 12. Mutual funds provide various disclosures to their shareholders about fees in a
12 written prospectus which includes a fee table that discloses the sales charges, operating
13 expenses, and other fees that investors pay as part of investing in the fund. Specifically, the fee
14 table discloses (1) charges paid directly by shareholders out of their investment such as front or
15 back-end sales loads and (2) recurring charges deducted from fund assets such as management
16 fees, distribution fees, and other expenses charged to shareholder accounts. The fees deducted
17 from the fund's assets on an ongoing basis are reported to investors as a percentage of fund assets
18 and are called the fund's operating expense ratio.

19 **Shelf-Space Agreements in the Mutual Fund Industry**

20 13. Retail broker-dealers have increasingly demanded compensation for selling
21 mutual fund shares that is over and above that received in the form of sales loads and other fees.
22 A shelf-space agreement occurs when a mutual fund pays this additional compensation in
23 exchange for the broker-dealer preferentially marketing its shares ("Shelf-Space Agreement").
24 Mutual fund complexes have made these additional compensation payments out of their own
25 resources ("Additional Cash Compensation") and from brokerage commissions for fund
26 portfolio transactions ("Directed Brokerage").

27 14. Shelf-Space Agreements typically are created when a mutual fund complex
28 executive enters into an oral agreement with an executive of a broker-dealer to exchange

1 Additional Cash Compensation and/or Directed Brokerage for a precious commodity: privileged
2 access to the broker-dealer's sales force and heightened visibility within a broker-dealer's
3 distribution or sales systems. The amount of this additional compensation typically has been
4 based upon percentages of the mutual fund shares sold by the broker-dealers and/or held for
5 certain periods of time by the broker-dealer's customers. Mutual fund complexes may
6 additionally pay flat fees for shelf-space or to sponsor events such as conferences and golf
7 tournaments.

8 15. The mutual funds, however, fail to disclose these Additional Cash Compensation
9 and Directed Brokerage arrangements or other incentives provided to broker-dealers selling their
10 funds. Specifically, the mutual funds fail to provide their investors a means to understand that
11 their broker-dealer is being paid extra to sell a particular fund. The mutual funds additionally
12 fail to disclose that when Directed Brokerage is utilized, fund assets are being used to pay for
13 premium "shelf-space" at the selling broker's office. These undisclosed payments may increase
14 costs to investors as well as create conflicts of interest between investors and the financial
15 professionals with whom they deal.

16 **Potential Increased Costs from Shelf-Space Agreements**
17 **in the Mutual Fund Industry**

18 16. Broker-dealers demand that the mutual fund complexes participating in their
19 Shelf-Space Agreements either pay in cash or in a multiple of that cash amount in the form of
20 extra commission business on fund portfolio transactions. Faced with that choice, some mutual
21 fund complexes paid the multiple with Directed Brokerage commission dollars rather than
22 paying for shelf-space with their own hard dollars.

23 17. In order to pay for shelf-space with these Directed Brokerage commissions,
24 mutual funds frequently conduct their portfolio transactions using multiple broker-dealers for
25 execution, step-outs, and other arrangements. These complex practices belie the notion that
26 mutual fund advisers merely consider the selling efforts of the broker(s) involved. These
27 practices instead bear all the hallmarks of barter arrangements in which brokerage (a fund asset
28 belonging to the fund shareholders) is traded to pay the mutual fund complex's costs for

1 preferential sales efforts by outside brokers. Depleting this brokerage commission asset as a
2 *quid pro quo* for shelf-space imposes additional costs on the fund because this asset is not
3 available to offset other fund costs. Put simply, this practice is a real and meaningful cost to
4 mutual fund shareholders because it consumes a fund asset that could otherwise be used to
5 negotiate lower commission rates, pay custodial, transfer agency and other fund expenses, or to
6 obtain any available cash rebates from third-party vendors.

7 **Potential Conflicts of Interest from Shelf-Space Agreements**
8 **in the Mutual Fund Industry**

9 18. Undisclosed Shelf-Space Agreements adversely affect the relationship between
10 broker-dealers and their customers. Shelf-space payments create an incentive for a broker-dealer
11 to highlight, feature or recommend funds that best compensate the broker-dealer or to meet other
12 promises rather than to recommend investments that meet the customer's personal investment
13 needs. The failure to adequately disclose these agreements prevents the prospective mutual fund
14 investor from recognizing this potential and/or actual conflict of interest.

15 19. Undisclosed Shelf-Space Agreements also adversely affect the relationship
16 between mutual funds and their shareholders. Mutual fund complexes typically employ wholly-
17 owned subsidiary entities to manage their mutual funds (fund advisors) and to coordinate
18 distribution and sales efforts (fund distributors). Fund distributors' and advisers' compensation
19 rates largely derive from mutual fund sales and the adviser's assets under management,
20 respectively. Shelf-space agreements tend to promote growth over quality, and accordingly,
21 threaten the financial positions of existing shareholders. The failure to adequately disclose these
22 agreements prevents the prospective mutual fund investor from recognizing this potential and/or
23 actual conflict of interest.

24 20. Mutual Fund complexes that use fund assets to promote the sale of fund shares
25 may also avoid paying fees out of their own pocket by using Directed Brokerage. Although
26 potential conflicts exist with respect to the use of other fund assets to pay for the marketing of
27 fund shares, the use of fund Directed Brokerage commissions exacerbates this conflict because
28 mutual fund directors cannot effectively ascertain a fund adviser's true motivations in selecting a

1 broker-dealer or monitor a distributor's involvement in that selection. Mutual fund complexes
2 further impede the directors' ability to protect shareholders by not clearly disclosing the Shelf-
3 Space Agreements to them.

4 21. Undisclosed Shelf-Space Agreements, accordingly, create unmanageable conflicts
5 of interest that may harm funds and fund shareholders. The intense competition among fund
6 distributors to secure a prominent position in the selling brokers' distribution systems creates
7 powerful incentives for mutual fund complexes to direct brokerage based on distribution and
8 sales considerations rather than quality and price considerations. These incentives may
9 adversely affect decisions about how and where to effect portfolio securities transactions and
10 impact the quality of portfolio transactions.

11 **SPECIFIC FACTUAL ALLEGATIONS CONCERNING PAD**

12 22. PAD's failure to adequately disclose to investors and prospective investors the
13 existence, details and significance of PAD's Shelf-Space Agreements constitute violations of the
14 CSL, as more fully alleged below.

15 23. During the period since at least January 1, 2000 through the present ("Relevant
16 Period"), PAD offered for sale and sold shares in the Funds.

17 24. PAD's offers for sale and sales of the Funds' shares, as alleged above, were made
18 by means of written communications in the form of mutual fund prospectuses and statements of
19 additional information ("Disclosure Documents").

20 25. During the Relevant Period, PAD entered into Shelf-Space Agreements with at
21 least fifty broker-dealers ("Shelf-Space Broker-Dealers").

22 26. During the Relevant Period, pursuant to PAD's Shelf-Space Agreements, PAD
23 agreed to pay Additional Cash Compensation and furnish Directed Brokerage transactions to the
24 Shelf-Space Broker-Dealers in return for: (i) heightened visibility of the Funds within the Shelf-
25 Space Broker-Dealers' distribution or sales systems; and (ii) privileged access to the Shelf-Space
26 Broker-Dealers' distribution or sales systems. (Hereinafter, the term "Shelf-Space Agreements"
27 shall refer to the agreements alleged in this paragraph.)

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1 27. During the Relevant Period, pursuant to the Shelf-Space Agreements, PAD paid
2 Additional Cash Compensation and caused Directed Brokerage commissions to be paid in the
3 combined amount of approximately \$79 million including approximately \$8.1 million in
4 Directed Brokerage.

5 28. Pursuant to the Shelf-Space Agreements, PAD received from the Shelf-Space
6 Broker-Dealers, some or all of the following consideration: participation in meetings with Shelf-
7 Space Broker-Dealer representatives regarding the Funds; the opportunity for the Funds to be
8 touted in communications with the Shelf-Space Broker-Dealers' customers such as on a broker-
9 dealer's internet website or in customer newsletters; placement of the Funds on a "preferred list,"
10 in a "partners program," or in a similarly-named group of mutual fund complexes receiving
11 preferential treatment at the Shelf-Space Broker-Dealers' offices, including through the Broker-
12 Dealers' intranet websites; and the ability to participate in certain programs, such as 529 plans or
13 retirement plans, exclusively available to mutual fund complexes paying for shelf-space.

14 29. The Disclosure Documents disclosed in general:

15 a. As to Directed Brokerage, that, subject to the rules of best execution, sales of the
16 Funds' shares may be considered a factor in the selection of broker-dealers to execute the Funds'
17 portfolio transactions; and

18 b. As to the payment of Additional Compensation, the Funds' distributor may from
19 time to time pay additional cash bonuses or other incentives to selected participating brokers in
20 connection with sale or servicing of the Funds' shares and on occasions such bonuses or
21 incentives may be conditioned upon the sale of a specified minimum amount of the Funds'
22 shares.

23 30. However, the Disclosure Documents and PAD failed to adequately disclose to the
24 Funds' shareholders and/or prospective shareholders that the Directed Brokerage and payment of
25 Additional Cash Compensation described in Paragraph 27 are intended to compensate the Shelf
26 Space Broker-Dealers for various services that the broker-dealers promised to provide in
27 exchange for such payments, including: Shelf Space Agreements; placement on the Shelf-Space
28 Broker-Dealers' "preferred" or "recommended" fund lists, including placement on Shelf-Space

1 Broker-Dealers' intranet websites; access to the Shelf Space Broker-Dealers' registered
2 representatives, including attendance at conferences and other meetings; assistance in training
3 and education of personnel; marketing support; and/or other specified services intended to assist
4 PAD in the distribution and marketing of the Funds.

5 **FIRST CAUSE OF ACTION**

6 (Violations of Corporations Code Section 25401)

7 31. Plaintiff refers to and realleges paragraphs 1 through 30, inclusive above, and
8 incorporates said paragraphs by reference as though fully set forth herein.

9 32. The Funds' shares offered for sale and sold by PAD, as alleged hereinabove, are
10 "securities" as defined in Corporations Code section 25019.

11 33. In offering for sale, and/or selling, the Funds' shares, PAD has violated
12 Corporations Code section 25401 by failing to disclose to purchasers and prospective purchasers
13 of the Funds' shares the matters alleged in paragraph 30 above ("Undisclosed Matters"), as the
14 Undisclosed Matters are "material facts" necessary in order to make the statements about broker
15 compensation and directed brokerage as set forth in the Disclosure Documents, in light of the
16 circumstances under which they were made, not misleading. More precisely, the Undisclosed
17 Matters are matters which a "reasonable investor" would consider important in deciding whether
18 to invest in the Funds' shares.

19 34. PAD's omissions of material facts were in connection with the offer and sale of
20 securities within the meaning of Corporations Code section 25017.

21 35. PAD's omissions of material facts took place within the State of California within
22 the meaning of Corporations Code section 25008.

23 **SECOND CAUSE OF ACTION**

24 (Violations of Corporations Code Section 25216(a))

25 36. Plaintiff refers to and realleges paragraphs 1 through 35, inclusive above, and
26 incorporates said paragraphs by reference as though fully set forth herein.

27 37. In offering for sale, and/or selling, the Funds' shares, and failing to disclose to
28 purchasers and prospective purchasers of the Funds' shares the Undisclosed Matters, PAD has

1 violated Corporations Code section 25216(a), pursuant to the definition of the phrase
2 “manipulative, deceptive, or other fraudulent scheme, device, or contrivance,” as set forth in
3 California Code of Regulations, title 10, section 260.216(b). That definition includes any
4 omission to state a material fact necessary in order to make the statements made, in the light of
5 the circumstances under which they are made, not misleading, if the person making the omission
6 knows or has reasonable grounds to believe that it is misleading.

7 38. The Undisclosed Matters are “material facts,” necessary in order to make the
8 statements about broker compensation and directed brokerage as set forth in the Disclosure
9 Documents, in light of the circumstances under which they were made, not misleading and PAD
10 knew or had reasonable grounds to believe that failing to disclose to purchasers and prospective
11 purchasers of the Funds’ shares, the Undisclosed Matters, was misleading.

12 WHEREFORE, plaintiff prays for judgment against PAD, as follows:

13 1. For a permanent and preliminary injunction, enjoining PAD, its agents, servants,
14 and employees, and all persons acting under, in concert with, or for them, from directly or
15 indirectly or in any other manner engaging in the conduct as above alleged in violation of
16 Corporations Code sections 25401 and/or 25216;

17 2. For an order that PAD pay to plaintiff, a civil penalty in the maximum sum of
18 \$25,000 for each violation of Corporations Code sections 25401 and/or 25216;

19 3. For plaintiff’s cost of suit incurred herein; and

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4. For such other and further relief as this Court deems just and proper.

Dated: September 15, 2004

Respectfully submitted,

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Attorney General of the State of California

THOMAS GREENE
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JEFFREY RICH
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